Allianz Real Estate

The enduring appeal and resilience of Japan multifamily investments

Executive summary

Japan multifamily offers an attractive cash-on-cash yield and risk-adjusted return, making it ideal for portfolio optimization.

- Japan's stable economy will be valued more than ever as the flight to safety gains traction in the face of escalated uncertainty caused by geopolitical conflicts, economic recessions and the public health crises.
- COVID-19 has accelerated structural socio-demographic trends that underpin the rental demand for Japan's multifamily housing in the long term.
- A deep and liquid capital market should mean that Japanese financial and real assets, as well as investments into Japan multifamily, remain appealing.
- Leasing performance has been resilient throughout the pandemic, with work from home yet to have a material impact.
- Investor interest in the sector is expected to remain elevated thanks to favorable funding conditions and portfolio re-weighting towards income stability.
- Manage-to-core and develop-to-core strategies will gather pace amid the search for higher yield and the prospect of positive rental growth.

Growth to remain stable post COVID-19

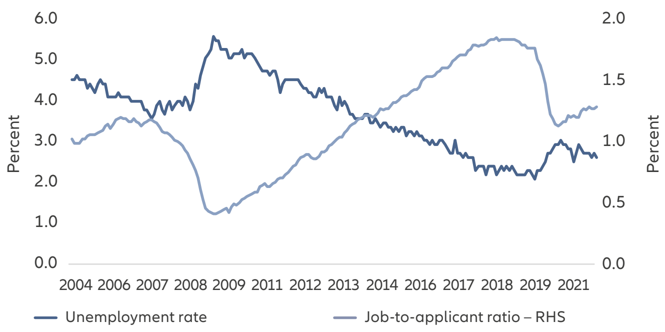
Japan, the world's third-largest economy by nominal GDP, has embarked on a steady growth path since introducing 'Abenomics' in 2012, comprising of three arrows: fiscal stimulus, monetary easing and structural reforms.

Pro-business policies, such as ultra-low interest rates and corporate tax cuts, have bolstered capital expenditures and enhanced corporate profitability. Hence, the unemployment rate has tightened while job availability has gradually grown (Figure 1). Moderate wage growth resumed in 2021 as a result of labor market resiliency (Figure 2).

Backed by the services and innovation-driven economic growth model, Japan is ranked sixth in the World Economic Forum's *The Global Competitiveness Report 2019*. According to JLL[1], Tokyo is the world's second most innovative city, surpassing other global cities like New York, Paris and London. Japan has also been seen as a safe haven thanks to its low sovereign risk and socio-political stability.[2]

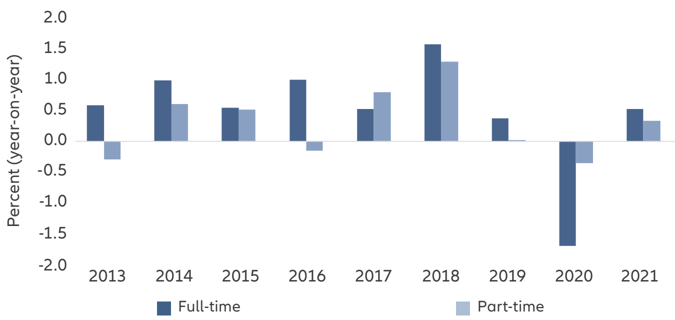
Japan has demonstrated significant economic resilience in the face of COVID-19's unfolding impacts. After the initial market disruptions, the Japanese economy exited from recession in the second half of 2020. Real GDP increased by 1.7% in 2021, following a 4.5% contraction in 2020, thanks to solid market fundamentals, unprecedented COVID-19 relief packages, and gradually controlled pandemic outbreaks.

Figure 1. **Employment conditions stay healthy**



Source: Refinitiv, Allianz Real Estate, February 2022.

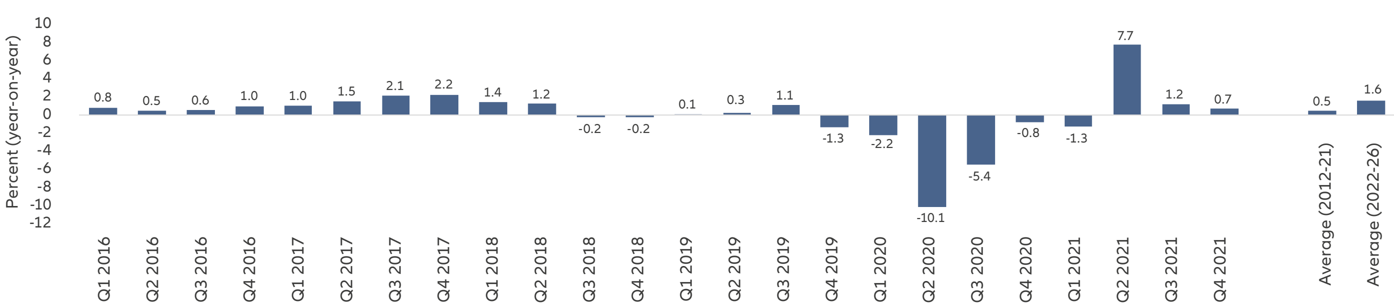
Figure 2. **Wage growth resumed from 2021**



Source: Refinitiv, Allianz Real Estate, February 2022.

In anticipation of higher vaccination rates and greater reopening, Japan's GDP is forecast to rebound and grow 1.6% per annum from 2022 to 2026, more than doubling the long-term (2012-2021) annual average of 0.5% (Figure 3).

Figure 3. **Japan's real GDP growth**



Source: Oxford Economics, Allianz Real Estate, February 2022.

[1] JLL, *Innovation Geographies Resilience and Recovery*, January 2022.

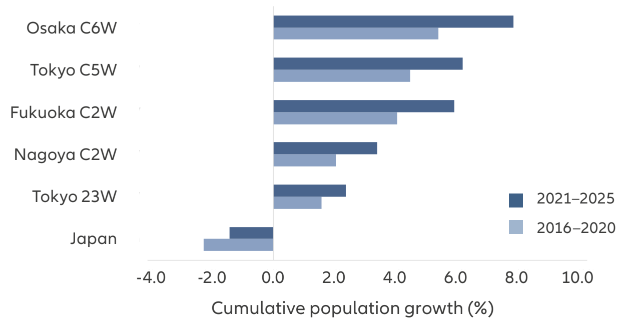
[2] Oxford Economics, *Japan Country Economic Forecast*, February 2022.

Secular drivers to cement rental demand

COVID-19 has accelerated pre-existing socio-demographic trends such as urban migration and reduced household size, which drive the structural growth of Japan multifamily.

The principal beneficiaries of this are the 'Big Four' cities of Tokyo, Osaka, Nagoya and Fukuoka, which are home to about 37% of Japan's overall GDP, 28% of the working-age population and 29% of employment.[3] Despite Japan's declining population, the Big Four cities, especially city center areas, have had and will continue to draw population inflows (Figure 4).

Figure 4. **Migration into the Big Four cities will continue**



Source: Statistics Bureau of Japan, National Institute of Population and Social Security Research, Allianz Real Estate, February 2022.

Note: Osaka C6W, for example, refers to the central six 'wards' of the city of Osaka. A ward is a sub-division of a city.

[3] Oxford Economics, *Japan City Economic Reports*, last updated in 2020.

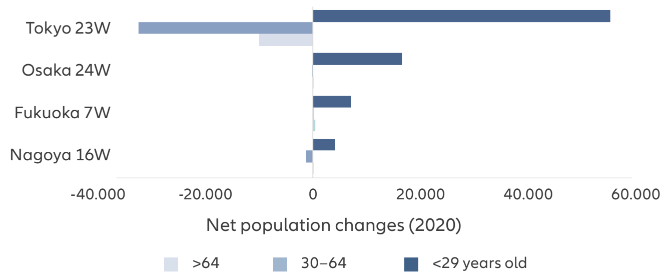
This trend will pick up pace as pandemic-induced social frictions propel more young people to seek better opportunities in employment, education and healthcare in large cities. In 2020, people aged below 30 dominated net migration into the Big Four cities, notably in Tokyo (Figure 5).

Moreover, foreign migrants enticed by the prospect of liberal immigration regulations are also expected to return to the Big Four cites once international borders reopen.

Between 2000–2020, the average household size decreased by 16%, from 2.67 to 2.25, while total households increased by 8.1 million, or 17%. Coupled with the delayed marriage age, single-person households reportedly climbed from 28% of total households in 2000 to 35% in 2015.[4] In response to evolving demographics, the size of new housing units for rent and sale has shrunk (Figure 6).

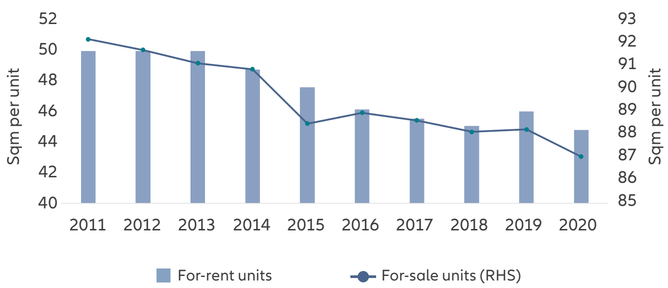
Overall, favorable structural trends expedited by the COVID-19 outbreak will cement long-term rental demand for Japan's multifamily residences.

Figure 5. **Young people drove population inflow amid COVID-19**



Source: Statistics Bureau of Japan, National Institute of Population and Social Security Research, Savills, Allianz Real Estate estimates, June 2021.

Figure 6. **The average dwelling size has been shrinking**



Source: Ministry of Land, Infrastructure, Transport, and Tourism; Allianz Real Estate, June 2021.

[4] Japan Population Census 2018.

Capital market strength to shore up investment

Japan has a gigantic and well-established capital market in tandem with the sheer size of the economy and a large investor pool.

The Japanese yen (JPY), presently the third international currency for cross-border settlement, warrants considerable liquidity and tradability of JPY-denominated assets.

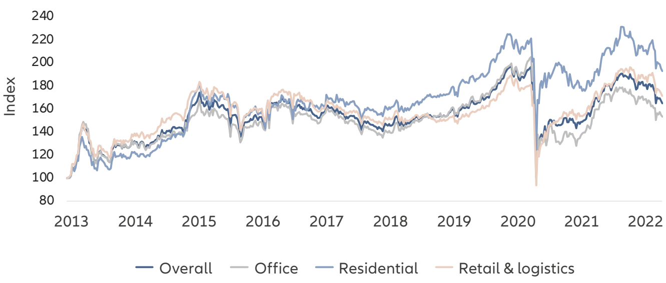
Japan's equity markets have mostly recovered in a stable growth environment since 2012. J-REITs' market capitalization, for example, nearly quadrupled 2012's levels to JPY 17.0 trillion in 2021 and accounted for over 13% of Japan's GDP.[5]

Remarkably, multifamily J-REITs have outperformed their J-REIT peers and were quickest to bounce back following the COVID-19 outbreak in early 2020, implying prominent investment appetite for the sector's stability and income-generating capacity (Figure 7).

Japan has the most mature institutional-grade multifamily market in Asia Pacific, accounting for over 60% of total sales from 2010 to 2019. With some mega portfolio deals, the sector defied gravity in 2020 with a marked 61% growth in transactions, jumping from USD 5.8 billion in 2019 to USD 9.4 billion (Figure 8), the largest on record.[6]

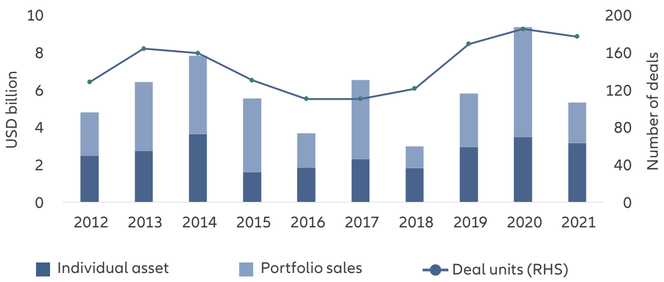
Following a stellar year in 2020, there was a sharp drop in investment in 2021 due to a plummet in portfolio transactions.

Figure 7. **J-REITs price indices by sub-sector**



Source: Bloomberg, Allianz Real Estate, February 2022.

Figure 8. **Japan multifamily direct investment by deal type**

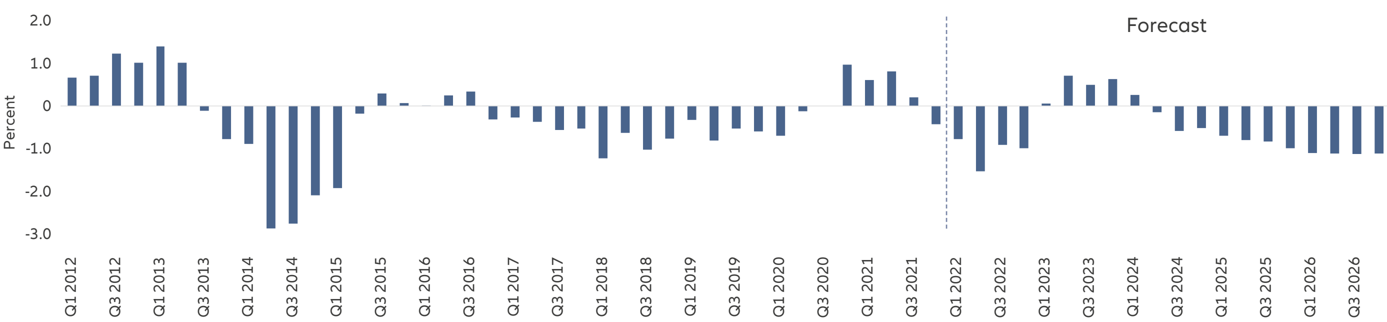


Source: RCA, Allianz Real Estate, February 2022.

However, the number of deals and individual asset sales were virtually on par with 2020 levels, meaning institutional investors are snapping up small-ticket multifamily assets due to limited availability.

Additionally, the continuation of an expansionary monetary policy and the accompanying negative real interest rates should help sustain the heated investment momentum (Figure 9).

Figure 9. **Real 10-year government bond yields to stay mostly negative**



Source: Oxford Economics, Allianz Real Estate, February 2022.

5 Bloomberg, Oxford Economics.

6 Real Capital Analytics, MSCI.

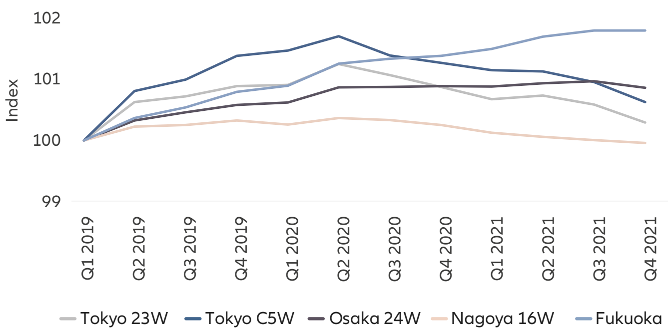
Leasing market to reinvigorate post COVID-19

The Big Four cities are forecast to see population growth continue in the medium term. However, COVID-related frictions, such as draconian lockdowns, labor displacement, border restrictions and work from home, have taken a toll in the near term (Figure 10).

As a result, there have been some fluctuations in rent and occupancy, mainly in Tokyo with less inflows of domestic and foreign migrants. In contrast, leasing performance in regional cities have generally been less volatile.

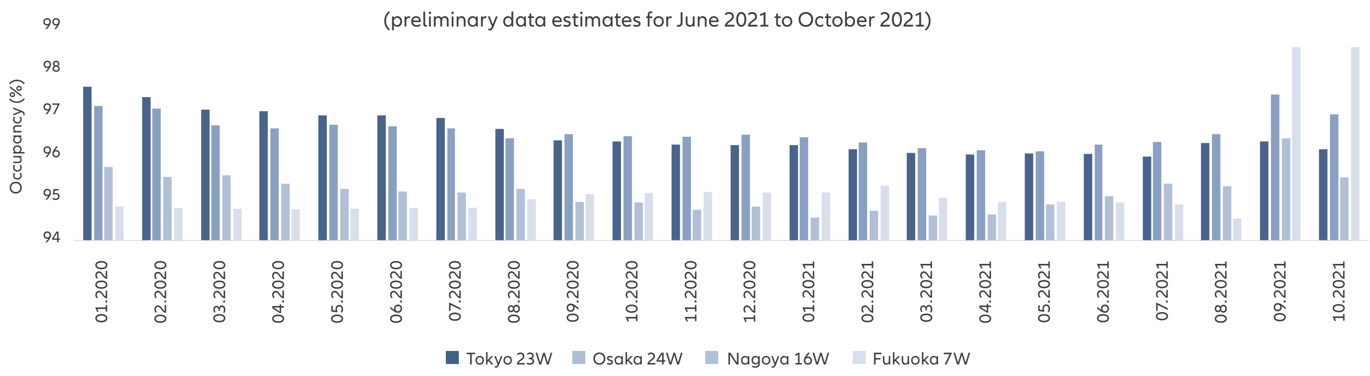
Despite lingering uncertainties, occupancies have stayed consistently above 94% across the board (Figure 11), and rents have fallen slightly, if at all, and have begun to rise in some locations.[7] According to Savills[8], after five straight quarters of losses since peaking in the first quarter of 2020, Tokyo central five wards' (C5W) average rents grew 2.1% year-on-year and 1.1% from the third to the fourth quarter of 2021, possibly an early indication of recovery.

Figure 10. **Population index of the Big Four cities**



Source: Oxford Economics, Allianz Real Estate, respective metropolitan governments, January 2022.

Figure 11. **Japan multifamily occupancy still aobove 94% since COVID-19**



Source: ARES Japan Property Index, Allianz Real Estate, February 2022.

It is also worth noting that, compared to the 10% rental decline recorded during the 2008 global financial crisis, Tokyo only saw a 6% rental correction[9], likely due to improved fundamentals and resistance to recessions.

Notably, work from home, accelerated by COVID-induced lockdowns, may increase rental demand for larger dwellings, particularly in outlying areas such as Saitama and Kanagawa in Greater Tokyo because worries about housing spaciousness and affordability might trump concerns about workplace proximity in the near term.

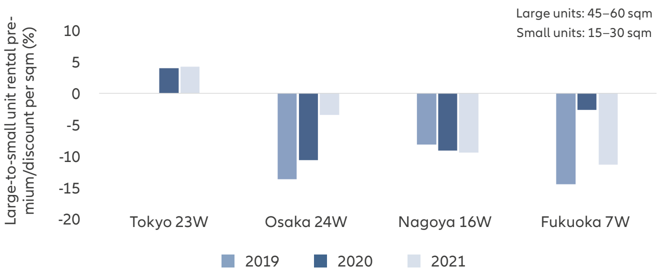
7 ARES Japan Property Index, Savills.

8 Savills, *Tokyo Residential Leasing Q4/2021*, January 2022.

9 ARES Japan Property Index, Savills.

In Tokyo, the popularity of work from home may grow as multinational corporations roll out worldwide remote working policies, which appeared to favor large units (45-60 sqm) and results in a rental premium over smaller units (15-30 sqm) (Figure 12). Regional cities dominated by domestic small and medium-sized enterprises, on the other hand, have exhibited virtually little work from home phenomena and consequently no such rental premium.

Figure 12. **Rental premium/discount of large units over small units**



Source: Savills, ARES Japan Property Index, Allianz Real Estate, January 2022.

Work from home is undoubtedly one of the emerging workplace themes, alongside technology, sustainability, employee well-being and amenities. Despite this, evidence of work from home mainstreaming in Japan has yet to materialize, owing to the country's high density, small dwellings, short commutes and the engrained corporate culture of working at the office.

Therefore, smaller units that house single-person households or young couples will benefit in the long term from structural demographic trends. Meanwhile, the anticipated return of people as a result of Japan's reopening from COVID-19 will likely reignite pent up demand for living near to the workplace, thus favoring city center dwellings.

Additionally, significant urban redevelopments, such as the facelift of the Shibuya Station area and Toranomon area in Tokyo, and the Umekita Project Stage 2 redevelopment and the planned integrated resort development in Osaka, would also reaffirm the appeal of city center dwellings.

Attractive returns to optimize portfolio performance

Capitalization rates for Japan's multifamily sector have continued to compress, attributable to the weight of capital, heightened investor interest and positive rental growth projections.

Nevertheless, supported by favourable borrowing conditions and ultra-low cost of debt, Japan multifamily may yield a compelling cash return compared to global peers.

For example, based on prevailing market conditions, prime Tokyo multifamily may generate a 6.9% cash-on-cash yield[10], far surpassing London (4.3%), Berlin (3.8%) and Paris (2.2%) (Figure 13).

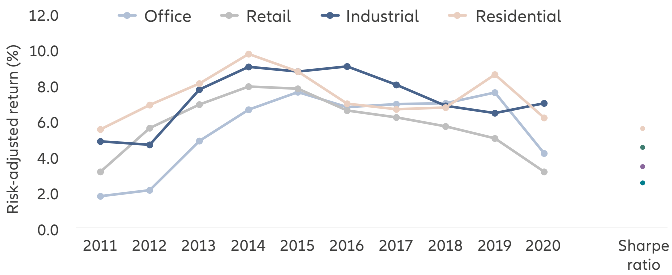
Japan multifamily has historically endured market downturns while offering an appealing risk-adjusted return on its ability to provide stable rental income. From 2011 to 2020, the multifamily sector had the best risk-adjusted return in Japan, followed by logistics (Figure 14).

Accordingly, this sector may aid in optimizing portfolio performance by improving returns while mitigating volatility. With a 10% exposure to Japan multifamily, a hypothetical global portfolio (by the MSCI Global Annual Property Index) will have a 5% reduction in total return volatility and a 2.5% rise in total return per unit of risk (Figure 15).

Figure 13. **Cash-on-cash yield among global prime multifamily markets (as of Q4 2021)**

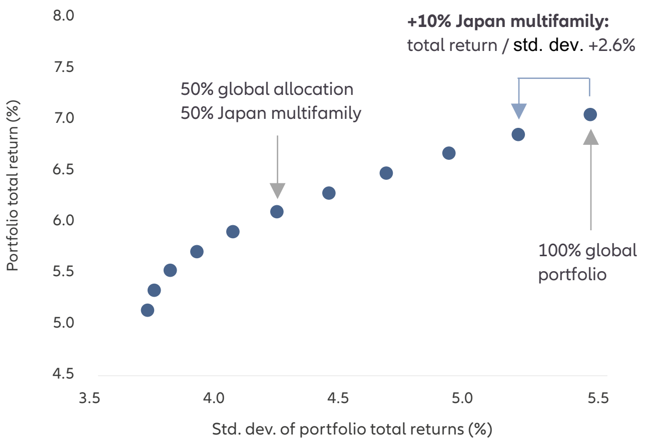
Source: JLL, Allianz Real Estate, December 2021.

Figure 14. **Japan multifamily has offered highest risk-adjusted return**



Source: MSCI, Allianz Real Estate, February 2022.

Figure 15. **Portfolio total return and volatility for various allocations to Japan multifamily**



Source: Allianz Real Estate Research based on MSCI data 2002-2022, February 2022.

Note: Global portfolio / allocation based on MSCI Global Annual Property Index (all property); Japan multifamily based on MSCI Japan Annual Property Index (residential segment).

10 Assume a 3.4% transaction yield for prime Tokyo multifamily as of Q4 2021, cost of debt 0.8%, LVR at 55-60%; for London, 3.25% transactional yield, cost of debt at 2.5%, LVR at 55-60%; for Berlin, 2.2% transactional yield, cost of debt 1.1%, LVR at 60%; for Paris, 2.2% transactional yield, cost of debt at 1.3%, LVR at 55-60%.

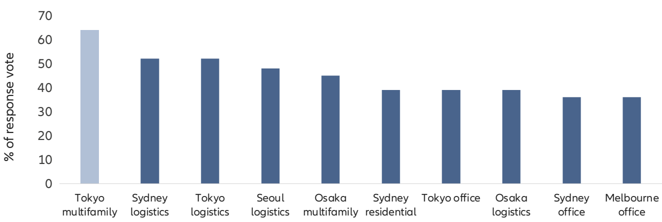
Investment spectrum to broaden out

In the era of constant uncertainty, the multifamily sector, together with Japan's stable economy, deep and liquid capital markets, and accommodative policy setting, should be more sought after.

Several industry surveys have shown that investment appetite for the sector will stand firm. For the first time, the ANREV investment intentions survey ranks Tokyo multifamily as the most preferred investment segment in Asia Pacific in 2022 (Figure 16). According to the PwC and ULI *Emerging Trends in Real Estate Asia Pacific 2022* report, Tokyo as a whole has the best city investment prospects in 2022 (Figure 17).

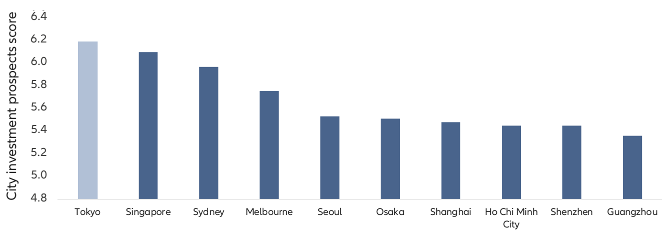
The buying spree may be bolstered further by new market entrants, in particular foreign investors wanting to deploy capital in pursuit of income stability, higher yields and portfolio diversification gains.

Figure 16. **Ranking of the most preferred city sector in Asia pacific 2022**



Source: ANREV, *Investment Intentions Survey 2022*, January 2022.

Figure 17. **Ranking of city investment prospects 2022**



Source: PwC, ULI, *Emerging Trends in Real Estate Asia Pacific 2022*, November 2021.

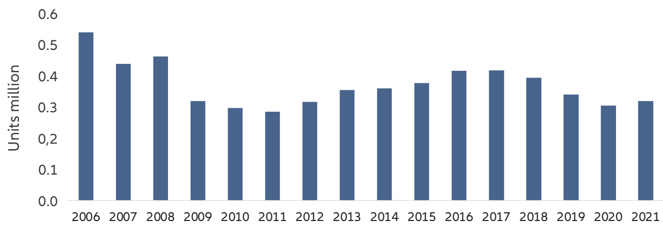
That said, the pace of investment could be hampered in the short term as investors navigate the mix of recurring pandemic outbreaks, complex macro climates and emerging market trends.

With capitalization rates for stabilized multifamily assets at all-time lows, investors could move up the risk curve by adopting the manage-to-core strategy, i.e., assuming some leasing risk in newly completed projects, especially in places with a large catchment area and good accessibility, connectivity and amenities.

Forward purchase commitments are also on the horizon, allowing investors seeking higher returns to fund the develop-to-core strategy. At the same time, the historically subdued for-rent pipeline development has reportedly ramped up in 2021, partly implying rising development momentum (Figure 18).

Looking further afield, regional cities such as Osaka, Nagoya and Fukuoka, which may provide higher yields, larger rental growth and better returns than Tokyo, may draw increasing investment flows.

Figure 18. **Japan's for-rent dwelling starts**



Source: Ministry of Land, Infrastructure, Transport, and Tourism; Allianz Real Estate, February 2022.

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